VZCZCXRO3961
PP RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV RUEHSR
DE RUEHLO #3097/01 3461642
ZNR UUUUU ZZH
P 111642Z DEC 08
FM AMEMBASSY LONDON
TO RUEHC/SECSTATE WASHDC PRIORITY 0656
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHBL/AMCONSUL BELFAST PRIORITY 1185
RUEHED/AMCONSUL EDINBURGH PRIORITY 1036

UNCLAS SECTION 01 OF 02 LONDON 003097

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD EINV UK
SUBJECT: Government's Pre-Budget Report: Too Bullish, Too Risky, Say Critics

REF: LONDON 02970

LONDON 00003097 001.2 OF 002

¶1. (SBU) Summary: The Pre-Budget Report (PBR), announced on November 24, has been widely criticized, from the size and nature of HM Treasury's fiscal stimulus package to HMT's perceived overly optimistic macroeconomic forecasts. On December 10, the Chancellor of the Exchequer Darling defended the PBR before MPs on the Treasury Select Committee. He explained the necessity of the fiscal package, dismissed concerns of deflation, and defended HMT's claim that the economy will start to recover in the second half of 2009. Prior to the Chancellor's appearance in front of the Committee, HMT officials met with MPs to explain the assumptions used to determine the macroeconomic forecast, the importance of the fiscal stimulus package and the reasoning behind abandoning HMG's fiscal rules. Independent economists told the Committee that HMT's forecast was optimistic and cautioned that any recovery would be contingent on increased bank lending. They expressed concern that public finances will not rebound as quickly as HMT expects. End Summary.

Chancellor Defends Pre-Budget Report

¶2. (U) Chancellor Alistair Darling defended his Pre-budget Report (PBR) before MPs on the Treasury Select Committee December 10. He maintained support for the macroeconomic forecasts made in the November 24 PBR (see reftel) - particularly that UK economic recovery will start in the second half of 2009. He said the forecast was consistent with the Bank of England's independent forecast and said the recovery will be aided by a low interest rate, the fiscal stimulus package, lower inflation and a flexible economy. He acknowledged that any recovery will be influenced by bank lending and said he will meet with his new lending panel and the chief executives of major banks December 11 to discuss strategies to increase lending. The Chancellor dismissed concerns of sustained deflation, saying that as the economy recovers, the summer's inflationary pressures will likely return. He welcomed President-elect Obama's calls for further U.S. fiscal stimulus. He said the UK's fiscal stimulus package was "absolutely necessary" and that if HMG had allowed the recession to become deeper and longer, the cost of doing nothing might have outweighed the cost of doing something.

HMT's Macroeconomic Forecast: The Verdict

¶2. (U) Dave Ramsden, HM Treasury's Chief Economic Adviser, defended the government's macroeconomic forecast before Treasury Select Committee MPs on December 9. Under heavy questioning from Conservative members of the Committee, Ramsden said the forecast for an economic recovery beginning July 2009 was underpinned by four factors: a sharp fall-back in commodity prices that will support household incomes; a large fall in interest rates; the fiscal

stimulus package; and a significant depreciation in sterling. While HMT expects output to fall at the beginning of next year, these forces, he argued, will lead to a recovery gathering pace in 2010. He assured the Committee that HMT has not underplayed the risks to growth but acknowledged that the Treasury's view was not shared by all independent forecasters.

¶3. (U) Independent experts who appeared before the Committee December 4 were less optimistic about the UK's outlook. Robert Chote, Director of the Institute for Fiscal Studies, said the PBR assumption that the stimulus package would reduce the depth of the downturn by about 0.5 percent was reliant on international action. If the UK's package was not accompanied by similar measures internationally, other countries, and not the UK, might reap the benefits of the UK's package. The economists criticized the Chancellor's statement that the UK was more resilient than other economies, saying the UK's high levels of household debt, massive housing bubble, and large financial sector left the UK badly placed to cope with a banking crisis. Roger Bootle, of Capital Economics, told MPs that getting banks lending again was critical to any recovery. A self-proclaimed free-marketer, he shocked MPs by calling on HMT to adopt the post World War II monetary policy of directed bank lending. He said HMG can't continue "encouraging" banks to lend. If banks continued to resist the stern warnings from the Chancellor, HMG would have to force lending. Bootle added that banks will be cautious to the point of reckless and will not act in the collective interest unless forced.

The Fiscal Stimulus: Temporary, Timely, Targeted
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¶4. (SBU) HMT officials told MPs that the fiscal stimulus package was designed to be temporary, timely, and targeted. They said the package introduced in the PBR met all three criteria. However, the Committee's independent witnesses were critical of HMT's use of a

VAT reduction. Simon Kirby, of the National Institute of Economic and Social Research, told MPs that trying to stimulate spending in a credit crunch without addressing the problem of credit constraints will have minimal impact. Professor Colin Talbot, of the University of Manchester, was worried that the VAT reduction could prove deflationary. If there is any stimulus effect, he said, it will be loaded towards the end of the VAT reduction period (end of 2009). (Comment: These views are in line with comments made to econoff by bank economists about the potential impact of the VAT reduction.)

Farewell To The Fiscal Rules

¶5. (U) HMT officials said the fiscal rules on debt were used to meet three objectives: achieve sustainable public finances in the medium term, protect investment, and support monetary policy in stabilizing the economy. (Note: HMG's two self-imposed fiscal rules were: the 'golden rule' that HMG will only borrow to invest and the 'sustainable investment rule' that public sector net debt will remain below 40 percent of GDP. End note.) Ramsden said against the background of a credit crunch it would be perverse to stick to these rules. Therefore, the Chancellor's PBR announced that HMT has "temporarily departed" from the rules and now abides by a temporary operating rule that requires HMG to "set policies to improve the cyclically-adjusted budget each year...so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy." Ramsden said HMT has not established a definite end date for the temporary rule. He could not say whether HMT will ever return to the previous fiscal rules.

¶6. (U) During the Treasury Committee's session with independent experts, Chote told MPs that the new temporary operating rule fails to act as a constraint on government actions. The economists were also skeptical of the Chancellor's forecasts for the public finances. According to the PBR, HMT expects tax receipts, as a proportion of GDP, to return to 2007-2008 levels by 2013-2014. The economists said that in normal circumstances, tax receipts do not return so quickly after a recession. They also warned that the

extent of the government debt will become an increasingly important factor in the cost of the debt. Eventually, borrowing will become significantly more expensive and its cost will begin to pose a considerable constraint on future borrowing.

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